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C O N F I D E N T I A L SECTION 01 OF 03 BAKU 000603

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TAGS: [ECON](#) [EFIN](#) [EPET](#) [ENRG](#) [PREL](#) [AJ](#)  
SUBJECT: NEARLY USD 1 BILLION BUDGET INCREASE WORRIES  
INTERNATIONAL FINANCIAL INSTITUTIONS IN AZERBAIJAN

REF: BAKU 573

Classified By: AMBASSADOR ANNE E. DERSE PER REASONS 1.4 (B, D)

¶1. (C) SUMMARY: According to the IMF Resident Representative, the Government of Azerbaijan may be planning a huge supplemental increase to the 2007 budget totaling between USD 750 and 1 billion, a 15 percent increase over the current budget that the IMF finds "worrisome." In a subsequent conversation, the IMF rep confirmed that the final supplemental budget figures ranged from USD 700 million to as high as USD 2 billion. He added that if fully implemented, the 2007 state budget expenditures would increase by 67 percent over last year's budget, the same rate of increase for the 2006 budget and a sign of undisciplined fiscal policy. The IMF agreed that the GOAJ's plans to submit an enormous 2007 state budget supplemental package would be a negative blow to Finance Minister Sharifov's plans to reign in government expenditures. While inflation was tame in April, the IMF expects inflation and currency appreciation to increase in June and July as government capital expenditures begin. The World Bank representative told the group that the recent Presidential decree instructing the government to present recommendations on improving the business climate was "positive" and could improve the Government of Azerbaijan's "Doing Business" ranking in the short-term. The Ambassadors also discussed the recent agreement between Russia, Kazakhstan and Turkmenistan to develop natural gas resources noting that while the deal was significant it left open possible future gas deals with Azerbaijan. END SUMMARY.

¶2. (C) On May 16 Ambassador Derse attended the German Embassy-hosted Revenue Management Group with local international financial institution (IFI) representatives and other Western Ambassadors. The IMF briefed on the current macroeconomic environment and provided a read-out on the IMF Board's recent discussion on Azerbaijan and its Article IV consultations. The World Bank representative told the group that the recent Presidential decree instructing the government to present recommendations on improving the business climate (reftel) was "positive" and could improve the Government of Azerbaijan's (GOAJ) "Doing Business" ranking in the short-term. In addition, the World Bank will assist the GOAJ in implementing any decisions to improve the business environment, including setting up a "one stop shop" and reducing or eliminating licenses. Overall, the World Bank rep noted that the decree "was a good start to do more next year."

HUGE SUPPLEMENTAL BUDGET  
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¶3. (C) The local IMF resident representative told the RMG participants that based on conversations in the Finance Ministry the GOAJ planned to submit a 2007 supplemental

increase to the state budget totaling between USD 750 million and 1 billion. The IMF rep characterized this enormous increase of approximately 15 percent over the current budget as "worrisome." In a subsequent conversation with EconOff, the IMF rep confirmed that the final supplemental budget figures ranged from as low as USD 700 million to as high as USD 2 billion. He added that if fully implemented, the 2007 state budget would increase by 67 percent over last year's budget, the same rate of increase for the 2006 budget, representing a sign of undisciplined fiscal policy. Initially, the Minister of Finance had told the IMF and others, including the Ambassador, that the supplemental budget would total only USD 200 million, balancing additional revenues with additional expenditures due to the January price increases. The IMF had also learned from Finance Ministry contacts that the line ministries had originally requested more than USD 2 billion in funding for the supplemental budget.

¶4. (C) The IMF has also heard rumors that the GOAJ may include plans to raise the minimum wage and pensions in the supplemental budget. Since government wages are indexed to the minimum wage, these salaries would also increase. The IMF rep stated that the GOAJ has already increased government salaries by 66 percent but that higher prices inflation were eroding real wages for most workers.

#### INFLATION AND PUBLIC EXPENDITURES

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¶5. (C) The two significant challenges facing the GOAJ are reducing inflationary pressures and ensuring long-term fiscal sustainability, according to the IMF. The IMF expects the GOAJ to increase public expenditures by 35 percent in 2008, a

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political decision driven primarily by the October presidential elections. The IMF has presented to the government a model projecting that Azerbaijan will outspend its oil revenues and deplete its Oil Fund by 2016 if it continues to spend at the current accelerated rate. According to the IMF, an optimal spending rate for 2008 would be 25 percent with subsequent years spending decreasing to single-digits. The IMF reiterated that the non-energy sector is growing weakly and that cotton production, once a major export, had fallen 20 percent.

¶6. (C) The IMF characterizes the current public expenditure plans as "unsustainable" amid declining revenues. The IMF compared Azerbaijan to Nigeria or Saudi Arabia during the 1980s when both countries had increasing spending cycle amid lower prices led to non-oil sector stagnation. The IMF fears that the GOAJ's current expenditure plans could lead the government to seek external and domestic borrowing, possibly causing a debt crisis. The IMF and EBRD representatives noted that there is a "huge appetite" for Azerbaijani bond issuances, since none exist in the market and that the international markets may not punish the government for bad economic policies at this time. According to the IMF, J.P. Morgan recently completed a USD 100 million debt issuance with the International Bank of Azerbaijan and the government is contemplating a USD 300-500 million sovereign debt issuance later in the year.

¶7. (C) The EBRD representative stated that the GOAJ could not maintain the growth in expenditures since the amount of available projects would decrease over the coming years. He added that the prioritization of infrastructure projects was key and that IFI participation in projects was crucial to ensure proper oversight and monitoring of procurement and project implementation. One Ambassador noted that the government was moving towards private financing of infrastructure projects. He gave as an example French bank BNP Paribas' funding of a major roadway from southern Azerbaijan to the Georgian border without IFI participation.

## IMF RECOMMENDATIONS

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¶8. (C) In the short-term, the IMF has recommended the GOAJ set a more flexible monetary target allowing the Azerbaijani manat to appreciate versus the dollar. In 2007, the manat has only appreciated approximately one percent, but that could quickly change in May and June when large capital expenditures begin and as local markets shift away from dollar purchases. Inflation in April was tepid at 0.4 percent. The IMF believes that after January's large price increases, local markets may have overreacted and overshot price increases leading to the slight increase in consumer prices. Despite the lull in the economic environment, however, the IMF predicts a resurgence in inflationary pressures in June and July. The IMF has also recommended that the GOAJ gradually reduce public expenditures increases in the hopes of maintaining fiscal sustainability.

¶9. (C) The IMF resident representative told the group that in 2008 the profit split between the GOAJ and the international oil consortium led by BP (AIOC) will favor the government leading to additional energy revenues. The group debated whether the GOAJ would reduce the volume of oil production in order to reduce available revenues. Most participants agreed that the GOAJ would probably not reduce oil production since international oil prices were so high.

## IMF REPORTS NOT PUBLISHED

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¶10. (C) As in previous RMG meetings, the IMF representative told the group that the GOAJ is balking at making public the Article IV staff report from the February 2007 mission. The GOAJ failed to make public the IMF's staff recommendations from the 2006 mission. The IMF said that the failure to publish these documents could have negative repercussions, as international banks use the IMF's reports to evaluate a country's risk.

## CASPIAN GAS DEVELOPMENTS

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¶11. (C) The Ambassadors discussed the recent agreement between Russia, Kazakhstan and Turkmenistan to develop natural gas resources. One Ambassador noted that the deal came during an official visit by President Putin and that it would provide the countries, especially Turkmenistan, an established gas export route. Another Ambassador indicated

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that the move by Russia was a "political security issue" and in response to other countries in the region (i.e. Azerbaijan) leaning more towards the West. The World Bank representative, a Polish national, told the group that the Kazakh president told the Polish president personally he would attend a May energy summit in Poland only to cancel at the last minute and send a deputy minister of energy. The group agreed that since it was a "political agreement" implementation may be slow leaving the door open to future plans with Azerbaijan.

¶12. (C) COMMENT: The GOAJ's plans to submit an enormous 2007 state budget supplemental package would be a negative blow to Finance Minister Sharifov's plans to reign in government expenditures. As noted by the IMF, Azerbaijan's current fiscal policy is unsustainable in the long-term but the economic reformers in the government appear unable to stem the demand for additional funds from different ministries. The National Bank has also told Embassy officers that the GOAJ would begin a program to appreciate the national currency substantially in 2007. While this move will reduce some inflationary pressures, it will further hurt exporters primarily in the non-energy sector. At the next RMG meeting, to be led by the U.S. Embassy, we will seek commitment from RMG members to seek a group meeting with Economic Development

Minister Babayev or the Finance Minister to resent the RMG's macroeconomic concerns. We wil also explore a possible call on President Aliye to present the group's concerns regarding the current economic situation. END COMMENT.  
HYLAND